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In this installment of The Endres Assessment, Endres, Doyle, and Reilly review New York's recently proposed tax amendments and discuss the broad implications that flow from them, particularly those affecting application of Public Law 86-272.

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We're all well aware of the cliché that nothing in life is certain except for death and taxes. Well, we think we can add one more certainty to that list: When the New York State Department of Taxation and Finance sneaks out guidance or other authority late on a Friday, it's never good news for taxpayers. That was the case when — late on Friday, April 29 — the department published updated versions of what it labeled "final drafts" of its draft corporation tax regulations.[1] Among other things, these new amendments to the draft regulations seek to severely limit the protections afforded out-of-state businesses under existing federal law — Public Law 86-272. This article reviews the department's proposed amendments and discusses some of the broad implications that flow from them.

New York's Long-Awaited Tax Reform Regulations

Since the enactment of New York's corporate tax reform legislation as part of the state's 2014-2015 budget, the department has published several versions of draft regulations, which provide nonbinding guidance on corporate tax reform, including in the areas of nexus, net operating losses, income and capital definitions, and apportionment. Though these regulations have been only drafts for the past several years and have not enjoyed the force and authority of regulations fully promulgated under the state's Administrative Procedure Act (APA), in the absence of other guidance, tax practitioners have found them useful in advising their clients. With this latest announcement, the department signals that it finally intends to begin the APA process to propose the drafts and then formally adopt them as regulations. Because the recent releases are intended to serve as the state's final draft regulations, the department has also "strongly encourage[d] timely feedback," setting a June 30 deadline for comments.

We appreciate the department's thoughtful process for perfecting the draft regulations and agree that further delays in starting the formal

[1] *See* New York State Department of Taxation and Finance, "Corporate Tax Reform Draft Regulations" (updated Apr. 29, 2022).

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APA process are unwarranted regarding the tax reform draft regulations. However, the new amendment to the drafts involving P.L. 86-272 did not arise from tax reform. So maybe that piece is worthy of more deliberation.

P.L. 86-272 Background

P.L. 86-272[2] is a federal law adopted by Congress in 1959. The law was designed to avoid a potential chilling effect on economic activity that could result from onerous multistate tax compliance. The argument goes that our economy works best when people and goods flow freely across the nation. If a corporation had to comply with each state's corporate income tax laws anytime a salesperson entered a state, the compliance cost, both in terms of money and attention, could prohibit taxpayers from operating as freely and efficiently as possible. Thus, Congress concluded that if an out-of-state corporation's activities in a state were geared to finding new markets and soliciting business, these limited activities should not subject the corporation to income tax compliance obligations in that state.

P.L. 86-272 prohibits a state from taxing out-of-state businesses on income derived from business activities in the state if their activities are limited to mere solicitation of orders for the sale of tangible personal property and the orders are then approved and filled from outside the state. Thus, for the law's protections to clearly apply, the following three requirements must be satisfied:

1. The tax at issue must be an income tax. Several states take the position that the law's protections do not apply to taxes not based on income (see, for example, Ohio commercial activity tax,[3] Texas franchise (margin) tax,[4] and Washington business and occupation tax[5]).
2. The in-state activities of the business seeking the protection of P.L. 86-272 must be limited to selling tangible personal property and the sales made must be approved and fulfilled from outside the state (sellers of services and digital products are typically not protected by the law).
3. The business's in-state activities must be limited to mere solicitation (some de minimis activities are also allowed). Solicitation means (1) speech or conduct that explicitly or implicitly invites an order, and (2) activities that neither explicitly nor implicitly invite an order but are entirely ancillary to requests for an order.[6]

It is important to note that the law allows a business to have a significant physical connection to a state, yet not have to comply with the state's income tax. For example, a corporation can have an employee or independent contractor regularly enter or even live in a state to solicit sales for the company's products if those orders are approved and fulfilled from outside the state. The business can provide vehicles for these salespeople and supply them with samples and promotional materials for complimentary display or distribution and still be protected against state income taxation under P.L. 86-272.

Finally, P.L. 86-272 provides significant protection even against state economic nexus rules. In New York, for example, an out-of-state corporation with no in-state physical presence would have nexus with New York and must pay its franchise tax if its annual sales into the state exceed $1,138,000.[7] But if the requirements of P.L. 86-272 are otherwise met, the out-of-state corporation is protected from this economic nexus rule. In fact, as discussed, this corporation can have sales over the economic nexus threshold and even have a physical presence in New York through its salespeople, yet still not have to pay the state's franchise tax if the requirements of P.L. 86-272 are otherwise satisfied.

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[2] Interstate Income Act of 1959; 15 U.S.C. sections 381-384.

[3] Ohio Rev. Code Ann. section 5751.02.

[4] Tex. Admin. Code 34 section 3.586(i).

[5] Washington Tax Determination No. 93-281, 14 WTD 035 (Oct. 27, 1993).

[6] *See Wisconsin Department of Revenue v. William Wrigley Jr. Co.*, 505 U.S. 214 (1992).

[7] *See* N.Y. Tax Law section 209; *see also* New York State Department of Taxation and Finance, Corporate Tax Reform FAQs. Before 2022, New York's economic nexus threshold amount was $1 million.

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Changing Circumstances and the Multistate Tax Commission's New Guidance

P.L. 86-272 was enacted more than half a century ago — the nation's economy and how interstate business is conducted have changed dramatically. When the law was enacted, the U.S. economy was primarily a mercantile-based economy in which, for the most part, markets were developed, and sales of tangible products were made through physical activities in a state. But 63 years later, the U.S. economy has transitioned to a service-based economy, built on a digital infrastructure that allows companies to find markets and sell products around the world. This raises the question: How has the application of P.L. 86-272 changed?

The Multistate Tax Commission, an intergovernmental association of state tax agencies whose mission, according to its website, "is to promote uniform and consistent tax policy and administration among the states," has issued various statements over the years concerning the proper application of P.L. 86-272 among its member states.[8] The MTC formally adopted an updated statement August 4, 2021, which made significant changes to how member states would treat out-of-state sellers using the internet to conduct business. Some of the more controversial changes that would defeat the existing protections of P.L. 86-272 include:

- Post-sale assistance to in-state customers via either electronic chat or email that customers initiate by clicking on an icon on the business's website. For example, the business regularly advises customers on how to use products after they have been delivered.
- The business places internet cookies onto the computers or other electronic devices of in-state customers. These cookies gather customer search information used to adjust production schedules and inventory amounts, develop new products, or identify new items to offer for sale.

Given how most businesses use the internet and considering how most websites function, it is not an overstatement to say that the MTC's new interpretation could effectively eviscerate P.L. 86-272's protections in most circumstances. And we find this entirely inconsistent with congressional goals of greasing the gears of interstate commerce. There is no better machine than the internet to encourage and support interstate commerce. But the commission is using the development of the internet economy as an excuse to throw sand in those gears. The MTC's policy change also comes at a time during which state tax systems have evolved to be more complicated, unique, and compliance-heavy than in any other time in history.

State income taxes are more prolific, diverse, and onerous to comply with than ever before. For instance, many of the businesses that will have filing requirements in additional states as a result of the MTC's new policies are flow-through entities, so there are going to be new burdens on the entities *and* their owners. The MTC's new policy does not acknowledge the new compliance burdens. And though we have not done an empirical study, we intuit that the cost to business taxpayers to comply with the new policies will, in many cases, exceed the additional tax revenue that will result from the enforcement of the new policies reflected in the updated statement.

Back to New York

Consistent with the MTC's statement, New York's revised draft regulations acknowledge P.L. 86-272 protections are for corporations engaged only in "the solicitation of orders via the Internet in New York State for sales of tangible personal property [where] the orders are sent outside New York State for approval or rejection." This includes an out-of-state internet vendor "presenting static text or images on its website" or engaging in specific, limited presale solicitation activities. But New York then blurs the line between protected out-of-state activities and unprotected in-state activities by noting that solicitation (which is protected under P.L. 86-272) does not include some activities that out-of-state corporations may engage in "via the Internet, including interacting with customers or

[8] "Statement of Information Concerning Practices of Multistate Tax Commission and Supporting States Under Public Law 86-272," July 11, 1986 (rev. 1993, 1994, 2001, and 2021).

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potential customers through the corporation's website or computer application." The practical result of this change could be that an out-of-state retailer of tangible personal property — even one without any physical presence in New York — may fall outside the protections offered by P.L. 86-272 simply by engaging in the types of online customer service activities that have become standard in the internet retail age.

The following examples in the draft regulations highlight this concern and are consistent with the MTC's updated statement:

> **Example 7**: A foreign corporation regularly provides assistance to its customers after its products have been delivered, either by email or electronic chat that customers initiate by clicking on an icon on the corporation's website. For example, the corporation regularly advises customers on how to use products after the products have been delivered. Since this activity does not constitute, and is not entirely ancillary to, the solicitation of orders for sales of tangible personal property, the corporation is not exempt from tax under this section.
>
> **Example 10**: A foreign corporation places internet cookies onto the computers or other electronic devices of is customers. These cookies gather customer search information that will be used to adjust production schedules and inventory amounts, develop new products, or identify new items to offer for sale. Since this activity does not constitute, and is not entirely ancillary to, the solicitation of orders for sales of tangible personal property, the corporation is not exempt from tax under article 9-A under this section.

New York is not a full MTC compact member. But there are other non-full-member states also seeking to generally conform to the commission's updated statement. On February 14, California issued a technical advice memorandum that, while not referencing the commission or its updated statement directly, nevertheless provided guidance largely consistent with its conclusions.[9] Rather than citing the commission's statement, California based its updated advice on *Wayfair*,[10] despite the fact that the U.S. Supreme Court's ruling in *Wayfair* did not interpret P.L. 86-272 and was concerned with sales tax, not corporate income tax.[11]

If we're being generous, we would say that these new interpretations of P.L. 86-272's protections will lead to counterintuitive results. But it might be more accurate to say that the proposed interpretations simply won't make any sense to most business owners. Consider that a non-internet business that has numerous salespeople living and working in a state and maintains a boatload of promotional and other property in the state might have no income tax obligation to that state under P.L. 86-272, while an internet business that has no physical presence in the state could have an income tax obligation because its employees, working entirely outside the state, engage in information exchanges with customers over the business's website. That sort of paradox is difficult to reconcile and could also implicate another federal law that is beyond the scope of this article — the Internet Tax Freedom Act[12] — which preempts state and local governments from discriminatory taxes on electronic commerce. We think discriminating between taxpayers based on whether customer service is delivered via an 800-number on the telephone or the internet on a computer is problematic.

New York's current, pre-corporate tax reform P.L. 86-272 regulations are a reasonably even-handed and traditional approach. New York might want to think twice before following the path staked out in the MTC's updated statement. One divergence from the commission's lead that might make sense would be to exempt from tax income from every business that has less than

[9] Cal. Technical Advice Memorandum No. 2022-01 (Feb. 14, 2022).

[10] *South Dakota v. Wayfair Inc.*, 138 S. Ct. 2080 (2018).

[11] Cal. Technical Advice Memorandum No. 2022-01, stating that "although the United States Supreme Court was not interpreting PL 86-272 in *Wayfair*, California considers the Court's analysis as to virtual contacts to be relevant to the question of whether a seller is engaged in business activities in states where its customers are located for purposes of PL 86-272."

[12] 47 U.S.C. section 151.

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$1,138,000 of receipts from New York sources and no traditional physical presence in New York. That would, at least, exclude from income tax compliance obligations those businesses with just a moderate slice of New York's market. And this would reconcile New York's economic nexus trigger and the outer limits of P.L. 86-272's protections.

As mentioned at the beginning of this article, the department has encouraged timely feedback on its final draft regulations by June 30. We expect New York's tax department has at least one subscription to *Tax Notes State*. But just in case, we're going to send it a copy of this article. ■

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